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SUPREME COURT of the UNITED STATES

OCTOBER TERM, 1929

No. 226

THOMAS A. EARLY, Receiver of the Farmers & Merchants National Bank of Lake City, Petitioner,

v.

FEDERAL RESERVE BANK OF RICHMOND,
Respondent

BRIEF IN OPPOSITION TO WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

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(34,357)

THE WILLIAM BYRD PRESS, INC., RICHMOND, VA.

SUBJECT INDEX

PAGE

Foreword 1
Grounds for Opposition 2
Answer to Point A 4
Answer to Point B (1) 10
Answer to Point B (2) 12
Answer to Point C 13
Conclusion 16

CASES CITED

Amer. Bank & Trust Co. v. Federal Reserve Bank, 256 U. S. 350, 41 Sup. Ct. 499, 65 L. Ed. 983 9
Amer. Bank & Trust Co. v. Federal Reserve Bank, 262 U. S. 643, 43 Sup. Ct. 649, 67 L. Ed. 1153 9
City of Douglas v. Federal Reserve Bank, 271 U. S. 489, 46 Sup. Ct. 554, 70 L. Ed. 1051 7
Equitable Trust Co. v. First National Bank, 275 U. S. 359, 48 Sup. Ct. 167. 13
Farmers and Merchants Bank of Monroe v. Federal Reserve Bank, 262 U. S. 649, 43 Sup. Ct. 651, 67 L. Ed. 825 9
Farmers National Bank v. Penn Bank, 123 Pa. 283, 16 Atl. 761 3
Federal Reserve Bank v. First National Bank, 277 Fed. 300 (U. S. D. C.) 3
Federal Reserve Bank v. Malloy, 264 U. S. 160, 44 Sup. Ct. 296, 68 L. Ed. 617 15
First National Bank v. Federal Reserve Bank (C. C. A. 8th), 6 Fed. (2nd) 339 7
Hunt v. Rousmanier's Admr's, 8 Wheat. 174 13
Midland National Bank & Trust Co. v. First State Bank of Sioux Falls, Minn. Nov. 30, 1928, 222 N. W. 274 3
Penn Bank v. Farmers National Bank, 130 Pa. State 209, 20 Atl. 150 3
Storing v. First National Bank (C. C. A. 8th), 28 Fed. (2nd) 587 3

STATUTES CITED

Federal Reserve Act, Sec. 16, 38 Stat. 265, 12 U. S. C. 360 7
Federal Reserve Act, Sec. 13, 40 Stat. 234, 12 U. S. C. 342 7

SUPREME COURT of the UNITED STATES

OCTOBER TERM, 1929

No. 226

THOMAS A. EARLY, RECEIVER OF THE FARMERS & MERCHANTS NATIONAL BANK OF LAKE CITY, PETITIONER,

v.

FEDERAL RESERVE BANK OF RICHMOND,
RESPONDENT

BRIEF IN OPPOSITION TO ALLOWANCE OF WRIT OF CERTIORARI

FOREWORD

The essential facts in this case are accurately, although briefly, stated in the petition for certiorari. We refer to the agreed statement of facts (Record pages 15-21) and the opinion of the Circuit Court of Appeals (Record pages 68-77) for a more comprehensive statement of the details of the transaction involved.

On pages 17-19 of the petition and brief appears an argument showing that the petition for certiorari is filed at a proper stage of the proceedings. The case was submitted upon an agreed statement of facts; therefore, only questions of law were involved. The decision of the Circuit Court of Appeals disposed of all such questions completely, and is therefore in substance a determination of the controversy, although not in form a final judgment. While we contend that the questions involved are not such as are usually reviewed by certiorari, we concede that the petition was filed at a proper time, and join with petitioner in respectfully requesting the court to consider the questions presented as if the decision of the Circuit Court of Appeals had been in substance as well as form a final judgment.

I

Grounds for Opposition

The reasons given for the granting of the petition are (Petition page 7):

First, that the case presents an important question of banking law arising under the Federal Reserve Act and involving the construction of regulations issued by the Federal Reserve Board under the authority of said Act, which has been decided by the Circuit Court of Appeals in a way probably untenable and probably in conflict with the applicable decisions of this court.

Our answer to this is that the case involved is the construction of a contract made by a Federal Reserve bank in pursuance of general authority granted by the Federal Reserve Act, and in pursuance of express permission contained in the Regulations of the Federal Reserve Board. There is no suggestion that the contract was ultra vires or void, and the decision below was rested entirely upon the construction and application of the contract.

Every decision construing a contract is dependent upon the terms of the particular contract under consideration, and citation of cases construing other contracts of the same general nature are seldom conclusive. We have found no decision of this court which appears to deal with a similar contract, but the decision of the Circuit Court of Appeals was in accord with prior decisions of state and other federal courts construing similar contracts. (See *Federal Reserve Bank* v. *First National Bank* (U. S. D. C.), 277 Fed. 300; *Storing* v. *First National Bank* (C. C. A. 8th), 28 Fed. (2nd) 587; *Midland National Bank and Trust Company* v. *First State Bank of Sioux Falls, Minn.*, Nov. 30, 1928, 222 N. W. 274; and *Farmers National Bank* v. *Penn Bank,* 123 Pa. 283, 16 Atl. 761), affirmed without opinion; *Penn Bank* v. *Farmers National Bank,* 130 Pa. State 209, 20 Atl. 150.

The second ground upon which review by certiorari is asked is that the decision of the Circuit Court of Appeals has probably allowed a preference in favor of the holders of checks presented by a Federal Reserve bank in the liquidation of a National bank. The question presented by the record was whether or not a sum of money was at the time of the failure due to the failing bank or whether it had before suspension been definitely appropriated by the act of the failed bank for the payment of checks presented to it. The principle of equality of distribution among creditors of a failed bank was involved only in the general sense that such principle is involved in all suits by the receiver of a National bank to recover claims said to be due to that bank.

The third ground upon which review by certiorari is asked appears to be substantially the same as the first; that is to say, that the case involves an important question of banking law of a Federal nature which has not been but should be settled by this court. As we have said above, the decision was rested upon the construction of a contract such as any bank might lawfully make with its customers. Federal Reserve banks are generally authorized to make con-

tracts and the Regulations of the Federal Reserve Board expressly permit each Federal Reserve bank to issue circulars governing the details of its check clearing and collection operation (Record page 47). There is no suggestion in the record that the precise method employed by the Federal Reserve Bank of Richmond as defined in the circular which it issued is identical with arrangements made by any other Federal Reserve bank.

We therefore submit that this case presents no question of sufficient general importance to require review by certiorari, and furthermore the decision of the Circuit Court of Appeals in construing and applying the contract between the parties is so plainly right that review by certiorari can serve only to prolong unnecessarily the litigation.

Answer to Petitioner's Point A

(Petitioner's Brief pages 25-30)

Federal Reserve Bank of Richmond's Circular No. 143 (Exhibit No. 2, page 47) is a complete statement of the terms and conditions upon which the Federal Reserve Bank of Richmond undertook to handle checks deposited with it. A copy of the circular was sent to every member bank concerned and accepted by it (Exhibit No. 4, Record page 61, and Paragraphs 7 and 9, Record page 17). The circular therefore was a complete contract defining the rights of the three parties concerned in the collection of each check, i. e., the depositing bank, which was entitled to receive payment; the drawee bank, which was bound to make payment; and the Federal Reserve Bank, which, as agent for its depositor, undertook to collect the check in the manner specified in the circular. The provision of the circular which is essential to the determination of this case is as follows (Record page 55):

> "Checks received by us drawn on our member banks will be forwarded in cash letters direct to such banks and each member bank will be required either to remit

> therefor in immediately available funds or to provide funds available to us to meet such cash letters within the agreed transit time to and from the member bank. Therefore, the amount of any cash letter to a member bank is chargeable against available funds in the reserve account of such member at the expiration of such transit time, which date will be shown on each cash letter. *The right is reserved, however, to charge a cash letter to the reserve account of a member bank at any time when in any particular case we deem it necessary to do so.*"

We italicize the last sentence because in the discussion of this point in the brief for the petitioner the last sentence is omitted in the quotation and ignored in argument, and it was upon this clause that the decision of the Circuit Court of Appeals was in a large measure rested. (See opinion of Parker, Judge, Record pages 69-73.) A comparison of petitioner's Point A, as it is stated in his brief, with the plain and positive language of the contract, appears of itself sufficient to refute the petitioner's proposition.

The petitioner's proposition is:

> "There was neither agreement of the parties nor understanding implied from the terms of collection to create an equitable lien or charge on the Reserve Balance as security for the payment of checks."

The language of the contract is:

> "The amount of any cash letter to a member bank is chargeable against available funds in the reserve account of such member bank at the expiration of such transit time, which date will be shown on each cash letter. The right is reserved, however, to charge a cash letter to the reserve account of a member bank at any time when in a particular case we deem it necessary to do so."

The first principle of the law of contracts is that as a man consents so is he bound. Reference to the situation

of the parties and to their probable objects is unnecessary when the contract between them is clear and unambiguous; but a consideration of the situation of the parties in this case will, we believe, make the intention of the parties more obvious.

The holder of a check is by law required to present it to the drawee bank and demand payment in cash. When a check is received by one who is at a distance from the bank upon which the check is drawn, presentation in person or by special agent is impracticable. The holder is therefore usually compelled to employ banks as agencies to make collection through banking channels. Thus, in the course of business each day the ordinary commercial bank receives on deposit or for collection checks drawn upon other banks in many widely separated places. It would not be economical for any commercial bank to maintain direct correspondence with an agent in every place in which a check might be payable, as this would entail the selection of a correspondent in each city, town, and village in the country, so commercial banks ordinarily forward checks to selected correspondents who will undertake to collect all checks payable in a specified area. Settlement with such correspondents for checks collected is effected either by remittance of the proceeds or by setting off liabilities for checks collected for such correspondents against demands for the proceeds of checks collected by them. The routing of any check may involve handling by several banks. A small California bank may deposit almost all checks received by it with a San Francisco correspondent. If one of these checks be payable in Virginia, the San Francisco bank, which probably has no correspondent in Virginia, may send the check to a correspondent in Chicago or New York, which will probably send it to a bank in Richmond, which latter bank probably undertakes to collect for its correspondents all checks payable in Virginia. The city bank which receives a check on banks in a certain area, eg., a Richmond bank, undertaking to collect all checks in Virginia, must

devise means for dealing with agents at each banking point in its territory. Two methods may be used: A check may be sent for payment direct to the bank upon which it is drawn, or it may be sent to another bank in the same place to collect from the drawee by presentation. In other words, the drawee may be the agent to collect from itself, or another bank may be used as agent to collect from it. Both methods have advantages and disadvantages. The former is the most expeditious, but places the drawee in a position where it represents conflicting interest, and so if it be in a weakened condition, is tempted to cancel the checks sent to it and so release the drawers, although it is unable to pay the amount to the forwarding bank, rather than return the check and confess its inability to meet the demands upon it. The latter system may be somewhat more safe, but it also involves the risk of loss from failure of the collecting bank.

When a check has been paid by the drawee, two methods of settlement with the forwarding bank are possible. The drawee, or other collecting bank, may remit the proceeds by a draft acceptable to its correspondent or by other methods of remitting money, or if the collecting or paying bank has a balance to its credit with the forwarding bank, this balance may be charged in accordance with arrangements previously made. The latter method is possible only when the collecting or paying bank has a regular account with the forwarding bank; but, when it is possible, it is obviously in many respects a simpler and safer method of dealing. The first method is called the "remittance" method and the second the "charge and credit" method.

The Federal courts and many State courts hold that the initial bank is in the absence of clear and positive agreement responsible for all the sub-agents through which the checks are routed (See *City of Douglas* v. *Federal Reserve Bank,* 271 U. S. 489, 46 Sup. Ct. 554, 70 L. Ed. 1051, and *First National Bank* v. *Federal Reserve Bank* (C. C. A. 8th), 6 Fed. (2nd) 339). Since banks receive only an incidental compensation for collecting checks, they naturally

seek to restrict or limit their liability for losses which they cannot avoid; but, since every such loss falling on the depositor tends to weaken his confidence in his bank, forwarding banks naturally and properly attempt to devise methods of dealing which will reduce such losses to a minimum, and when depositors assume the risk of such losses, they are naturally much interested in precautions which will be taken to avoid such losses and the methods which will be used in dealing with sub-agents.

Prior to the inauguration of the Federal Reserve System, banks were dependent upon such arrangements as they could make with correspondents. It was evident, however, when the Federal Reserve banks were established, that if each Federal Reserve bank could collect all checks within it's district by direct dealings with the bank upon which the check was drawn, or through some other bank in the same place, and could collect all checks not payable in their own districts through the Federal Reserve bank of the proper district, then a regulated and orderly system for the collection of checks could be established in place of the somewhat irregular system which had been in use; but under the new system the Federal Reserve bank would merely perform functions of the same nature as those previously performed by city banks collecting checks for depositors.

Under the Federal Reserve Act Federal Reserve banks were required to receive on deposit checks upon solvent member banks (Federal Reserve Act 16, 38 Stat. 265, 12 U. S. C. 360) and authorized to receive for collection checks upon any bank in their districts (Federal Reserve Act 13, 40 Stat. 234, 12 U. S. C. 342). When Federal Reserve banks were authorized as above to receive checks on non-member banks, such banks were under certain conditions allowed to open clearing accounts with Federal Reserve banks and deposit checks with Federal Reserve banks for collection. Such non-member banks are in the position of member banks so far as the clearing and collecting of checks is concerned. If a non-member bank does not desire to open a clearing

account, but is willing to remit at par for checks sent it by the Federal Reserve bank, the Federal Reserve bank can make an arrangement with it whereby the non-member bank will remit in a satisfactory way for checks upon itself.

The difficulties which may prevent the handling of checks upon non-member banks were elaborately discussed by this court in *Farmers and Merchants Bank of Monroe, et als,* v. *Federal Reserve Bank of Richmond,* 262 U. S. 649, 43 Sup. Ct. 651, 67 L. Ed. 825, and likewise in *American Bank and Trust Company, et als,* v. *Federal Reserve Bank,* 256 U. S. 350, 41 Sup. Ct. 499, 65 L. Ed. 983, and same case 262 U. S. 643, 43 Sup. Ct. 649, 67 L. Ed. 1153.

In this case we are concerned only with dealings with a member bank and we have digressed to describe the relationship of the other two classes; that is to say, non-member clearing banks which have clearing accounts, and non-member remitting banks, only in order that the distinction in the use of these terms in the Regulation of the Federal Reserve Board may be apparent.

In collecting checks drawn upon non-member remitting banks it is obvious that only the "remittance" method can be used, but in collecting checks drawn upon member banks and clearing non-member banks either the "remittance" method or the "charge and credit" method may be used. Federal Reserve Board therefore authorized each Federal Reserve bank to select the method deemed most convenient in dealing with the latter classes (Regulation J, V. 4, Record page 46). The Federal Reserve Bank of Richmond adopted the "charge and credit" method (Circular No. 143, Paragraph headed "Our Cash Letters to Member Banks," Record page 55).

The circular made a complete statement of the method which would be used and expressly provided that checks sent to a member bank were, unless returned, absolutely chargeable to its reserve account, the actual entries being made in accordance with a schedule determined by the time necessary for a letter to reach the member bank and return

checks or an acknowledgment to reach Richmond. In the case at bar the Lake City bank acted under this contract, cancelled the checks, and thereby created an irrevocable liability for the amount of these checks and an irrevocable right on the part of the Federal Reserve Bank to charge them to its reserve account. The actual entry was deferred merely as a matter of accounting convenience. The right became irrevocable when the checks were cancelled.

If the provisions of the circular construed in the light of the situation do not mean that the reserve balance is to be applied upon all checks cancelled by the Lake City bank and not returned, we are unable to see that any force or effect may be given to the provisions of the circular which we quoted; and, of course, it is an elementary rule of construction that every provision of a contract was intended to have some substantial effect.

Answer to Petitioner's Point B (1)

(Petitioner's Brief pages 30-32)

The argument of petitioner in this section of his brief seems to be directed to the demonstration of the proposition that the provision in Circular No. 143, by which the reserve balance was made chargeable with the amount of the checks sent to the Lake City bank, was not essential to the successful operation of the check clearing or collection system of the Federal Reserve Bank.

We do not contend that no method of collecting checks upon member banks could be adopted other than the one adopted by the Federal Reserve Bank of Richmond, but we say that this method was the one which was duly adopted and upon the faith of which the depositing banks acted, and knowing this and consenting to this the Lake City bank acted. Furthermore, we contend that this method allows the ready use of the reserve of the member bank for its chief purpose. The object of a reserve is to enable a bank to meet withdrawals. Withdrawals are commonly made by

checks. Checks are presented in three ways: (1) By holders at the counter of the drawee bank; (2) By other banks in the same town; (3) By out-of-town banks through the mails.

Very few checks are presented in the first way. Checks presented in the second way are usually handled through a local clearing house, or are set off against checks on the presenting bank and only the net balance is paid. Perhaps the majority of all checks on a bank, especially if it be in a small town, are presented by mail. Since it is known that a Federal Reserve bank will collect a check upon any of its members in a minimum time and with no charge, the majority of all checks held by persons in other places, perhaps, in the case of banks in small towns, a majority of all checks on the bank are presented through the Federal Reserve bank. Payments for such withdrawals can be made most conveniently to the Federal Reserve bank from funds already in its hands, for in such a case a mere adjustment of the account closes the transaction.

The daily receipts of a bank are chiefly in the form of checks on other banks. Checks on all banks and many nonmember banks are collectible through Federal Reserve banks; hence a member bank can deposit with its Federal Reserve bank many checks on other banks. The proceeds of these checks when collected are credited to the reserve account of the depositing bank and will thus counteract the depletion made by payment of checks presented through the Federal Reserve banks. The withdrawals from and increments to the reserve being made through the same channel, unnecessary transfers of funds are avoided; so that the method under which a check is chargeable to the reserve account of the drawee bank if not returned is a convenient method of effecting the collection of the check, and one which affords to the holder of the check as much protection as can be afforded under practical banking conditions.

Petitioner lays stress upon the fact that the reservation

of the right to charge the reserve balance with checks accepted and cancelled by a member bank is not always a complete protection. The case at bar illustrates this, but also illustrates that it will often times afford protection. Courts of course may not refuse to enforce contracts merely because circumstances may be suggested in which the contract would not be of subtsantial value to the obligee.

Petitioner emphasizes the fact that the protection afforded to depositors in the case of checks on members banks is greater than the protection afforded in the case of checks upon non-member remitting banks. The mere fact that parties are not able to protect themselves in some transactions is of course no reason for failing to allow them the full benefit of the provisions of their contract in cases to which the provision is applicable.

Answer to Petitioner's Point B (2)

(Petitioner's Brief pages 32-34)

This point appears to depend upon the proposition that the Federal Reserve Bank was an agent of the Lake City bank to pay the checks in question. We are unable to see any element of agency in the relation of the parties. The Federal Reserve Bank was an agent of the depositing banks to collect the checks from the Lake City bank. The checks were entrusted to the latter upon the condition that they were chargeable against its reserve account unless returned. They were not returned and the question is: Did the suspension of the Lake City bank annul the condition upon which the checks were entrusted to it? This question has been so fully answered by the opinion of Judge Parker (Record page 74) that further discussion seems superfluous.

If the relation of the Federal Reserve Bank to the Lake City bank resembles an agency in any respect, it is an agency coupled with an interest, for the Federal Reserve Bank was obliged to secure payment for the checks deposited with it, if possible, and therefore had an interest

in securing such payment. Such an agency is irrevocable and is in effect an assignment (See *Hunt v. Rousmanier's Admr's,* 8 Wheat. 174).

It is elementary that the receiver in such a case can enforce such demands as the insolvent bank could have made at the moment of its suspension. If the Lake City bank had called the Federal Reserve Bank by telephone on the afternoon of Saturday, October 9, 1926, and had stated to the Federal Reserve Bank that the checks in the letters of October 7th and 8th had been cancelled and charged to the drawers and so could not be returned, but had then demanded that the Federal Reserve Bank should ship to the Lake City bank the amount of the reserve balance, leaving the checks unpaid and with no provision for their payment, would the Federal Reserve Bank have been bound to ship the money or could it have rightfully replied to this demand by saying that the balance would be held and applied on the checks, as provided in the contract between the parties? We submit that this question can be answered in one way only—that is, as the Circuit Court of Appeals answered it.

Answer to Petitioner's Point C

(Petitioner's Brief pages 35-39)

This section of petitioner's brief is confined to the proposition that the decision of the Circuit Court of Appeals is inconsistent with the principles of law enunciated by this court in *Equitable Trust Company* v. *First National Bank,* 275 U. S. 359, 48 Sup. Ct. 167 (erroneously cited in petitioner's brief as 257 U. S. 359). The Circuit Court of Appeals discussed the above decision fully and pointed out that the facts bore no analogy of the facts of the present case. A statement of the facts in that case is the best method of distinguishing it.

Knauth, Nachod and Kuhne were bankers apparently dealing in foreign exchange and had a contract with the

First National Bank of Denver whereby the latter might draw drafts on banks in foreign countries and the former would arrange for the payment of such drafts on presentation. In pursuance of the agreement First National Bank of Denver drew a check or draft on Banca Commerciale Italiana and requested Knauth, Nachod and Kuhne to protect the same. They requested Banca Commerciale Italiana to honor the draft for their account. Banca Commerciale Italiana upon receipt of the request from Knauth, Nachod and Kuhne charged the amount to their account and credited it to a general account called "Drafts Payable." It appeared that these latter entries were solely for the convenience in accounting between Knauth, Nachod and Kuhne and Banca Commerciale Italiana and that First National Bank of Denver did not know how or from what funds payment would be made, relying solely upon their agreement with Knauth, Nachod and Kuhne, and depending on them to procure payment of the check or draft. It also appeared that in previous similar cases Banca Commerciale Italiana had frequently cancelled such entries and transferred funds from "Drafts Payable" back to the general account of Knauth, Nachod and Kuhne, acting solely upon the directions of the latter.

Before the check or draft above mentioned was presented Knauth, Nachod and Kuhne were adjudged bankrupts. The Equitable Trust Company was appointed trustee of their estate. First National Bank of Denver, having, as drawer of the draft, been compelled to pay the amount to the holder, claimed that the transaction above amounted to an equitable assignment of or the creation of a trust in the funds held by Banca Commerciale Italiana to the credit of Knauth, Nachod and Kuhne. The majority of this court held that there was no equitable assignment and that no trust was created. As the division in this court indicates, it is always difficult to determine equities of a third person under a contract to which he is not a party but from which he may expect some incidental benefit. Perhaps no single test may

be applied to all cases, but knowledge of the contract on the part of the equitable claimant is generally essential. The claimant can seldom contend successfully that he has an equitable claim arising from a contract of which he was ignorant.

The opinion of the majority of the court is based upon the fact that First National Bank of Denver had contracted with Knauth, Nachod and Kuhne alone and were strangers to and ignorant of the agreement with Banca Commerciale Italiana, so that no reliance could have been placed upon the dealings between Knauth, Nachod and Kuhne and its foreign correspondent. In the case at bar every bank which deposited with the Federal Reserve Bank a check on the Lake City bank was bound by the terms of the circular and entitled to the benefit of every provision in it. The terms of the circular were the inducement for the deposit of the checks. It is negligent to send a check to the drawee without express authority or to adopt any method of settlement with the drawee except payment in lawful money unless the depositor has approved the method employed (See *Federal Reserve Bank* v. *Malloy*, 264 U. S. 160, 44 Sup. Ct. 296, 68 L. Ed. 617). The Federal Reserve Bank had, therefore, no authority to surrender these checks to the Lake City bank except upon the terms and conditions set out in the circular, and by the express terms of the circular the checks it surrendered to the drawee bank were chargeable to its reserve account if not returned. If the Federal Reserve Bank had attempted to waive this condition, it would have rendered itself liable to the depositing banks. To deny effect to this condition is to abrogate an essential provision of the contract under which the checks were deposited by the member banks and under which they were entrusted to the Lake City bank, for the depositing banks had consented to the surrender of the checks to the Lake City bank upon the terms and conditions stated in the circular and upon no other terms.

CONCLUSION

We submit in conclusion that the decision of the Circuit Court of Appeals depends entirely upon the construction of a contract between the Federal Reserve Bank of Richmond and its member banks, and so involves no important question of general law, and, furthermore, the construction placed upon the contract by the Circuit Court of Appeals is so plainly right that a review by certiorari will be inappropriate and would not serve to promote the ends of speedy justice.

Respectfully submitted,

M. G. WALLACE,

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